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## PROBLEMS OF MINORITY SHAREHOLDERS IN MICHIGAN CLOSE CORPORATIONS\*

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THE kind of corporation Michigan lawyers most often deal with is the so-called "close" or "closely held" corporation. The close corporation has relatively few shareholders and its stock is not listed on an exchange or regularly dealt in by brokers. A close corporation is usually a small enterprise, although it need not be since the scope of operations and the number of employees are not determinative of whether a corporation is closely held. This article will discuss the special problems of this type of corporation and its shareholders and the impact of the Michigan General Corporation Act<sup>1</sup> on these problems. In addition some of the powers and rights of minority shareholders in close corporations are discussed. Finally, methods of tailoring the corporate form of business to make it more serviceable in a closely held business enterprise are suggested.

### I

#### DISTINCTIVE CHARACTERISTICS AND NEEDS OF CLOSE CORPORATIONS

In a close corporation the shareholders usually live in the same geographical area, know each other well and are acquainted with each other's business skills. All or nearly all of them typically are active in the business as directors, officers or key personnel. They commonly think of themselves as "partners" and want the power that partners have to choose their future business associates. Employment by the corporation is often the sole or principal source of income for some or all of the shareholders. Thus, the typical shareholder in a close

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1. Mich. Comp. Laws §§ 450.1-192 (1948), Mich. Stat. Ann. §§ 21.1-194 (1963).

corporation is not simply an investor; he wants the rights of a co-owner and a voice in management and control.

As stock in a close corporation does not have an established market, valuation of shares for estate tax and other purposes is difficult. Furthermore, a shareholder who becomes dissatisfied with the way the corporation is being managed may find that he cannot dispose of his shares and get out of the company without suffering severe financial loss. Another characteristic of a close corporation is that tax considerations often control business policies, particularly dividend policies.

One reason why lawyers advising businessmen in a close corporation have encountered difficulties is that legislators and judges in the past have not always realized that the close corporation differs radically in its characteristics and needs from the big, public-issue corporation.<sup>2</sup> As a general proposition, legislatures have applied to the close corporation the same statutory rules applied to the public-issue corporation.<sup>3</sup> Similarly, the courts, in establishing rules for governing business organizations, frequently have failed to distinguish between a corporate giant such as General Motors and the incorporated "hot dog" stand.<sup>4</sup>

Even the practitioners' form books have been geared to the public-issue corporation, neglecting the needs of the closely held enterprise. A form book is likely to contain specimen provisions selected from the files of large corporate law departments and thus splendid for the huge public-issue corporations for which they were drafted, but ill-adapted indeed to a close corporation.

Under any corporation statute in this country, the lawyer organizing a close corporation or advising businessmen already operating a closely held business in the corporate form is faced with complex problems. It is difficult to set up a legal framework that will protect minority shareholders and at the same time retain sufficient flexibility in the corporate organization to meet future contingencies and take advantage of unexpected opportunities that may arise.<sup>5</sup>

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2. But see *Leland v. Ford*, 245 Mich. 599, 606, 223 N.W. 218, 221 (1929).

3. See, e.g., ABA Model Bus. Corp. Act (1964). Similarly, the Michigan General Corporation Act does not distinguish between closely held and public-issue corporations. Mich. Comp. Laws §§ 450.1-192 (1948), Mich. Stat. Ann. §§ 21.1-194 (1963).

4. "[W]hen a private business or a partnership has become incorporated under the general law, and greatly favored . . . by restricted liability, there is no reason for making any distinction between such a corporation and others, and our statutes make none." *In re Klaus*, 67 Wis. 401, 406-07, 29 N.W. 582, 584 (1886). But see *Leland v. Ford*, 245 Mich. 599, 606, 223 N.W. 218, 221 (1929).

5. See generally F. O'Neal & J. Derwin, *Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises* (1961).

## II

RESTRICTIONS ON THE TRANSFER OF SHARES AND  
ARRANGEMENTS FOR BUY-OUTS

Free transferability of shares—one of the traditional attributes of the corporate form of business—is usually not desirable in a closely held enterprise. As has been indicated already, the participants want to be in a position to choose their future business associates. They are in constant and intimate contact and can be thought of as a business team. One may be a chemist, one a salesman and one an executive who manages the corporation's internal operations and its financial affairs. All of them want to be certain that anyone who comes into the enterprise will be congenial and will provide skills that will contribute to the success of the business. In particular, the participants may want to protect themselves against having to accept as an associate the widow or son of a deceased shareholder. Furthermore, the participants do not want competitors to be able to buy into the corporation and gain access to corporate records.<sup>6</sup>

If the participants in a close corporation are well-advised, they usually will not want a shareholder who is not going to work actively in the business. An inactive shareholder is undesirable because his interests conflict with those of the active shareholders. In order to minimize taxation active shareholders usually withdraw most of the earnings of the corporation in the form of salaries rather than dividends; on the other hand, inactive shareholders, not being in the corporation's employ, want to keep salaries low and dividends high.<sup>7</sup>

Since the enactment in 1958 of Subchapter S of the Internal Revenue Code,<sup>8</sup> which permits close corporations meeting certain requirements to elect a tax status roughly similar to that of a partner-

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6. See, e.g., *Hutson v. Brown*, 248 Ala. 215, 26 So. 2d 907 (1946); *State ex rel. Watkins v. Cassell*, 294 S.W.2d 647 (Mo. App. 1956).

7. As dividends are generally declared out of corporate profits, their declaration results in double taxation: first the company must pay an income tax on the profits realized by the corporation and then the individual shareholders are taxed on the proceeds of the dividend. Int. Rev. Code of 1954, § 1; Treas. Reg. § 1.61-9 (1957). To avoid this reduction of net return to the shareholders and still allow the participants to realize immediate income from the enterprise, most closely held corporations set officer-shareholder salaries at amounts which are as high as possible and yet qualify as corporate business deductions.

As the statutory standard permits a corporation to deduct only a "reasonable allowance for salaries or other compensation for personal services actually rendered," Int. Rev. Code of 1954, § 162(a), only active shareholders can receive salaries for tax purposes; and an attempt to compensate an inactive shareholder by means of a salary will be treated as a disguised dividend and taxed as such. See Treas. Reg. § 1.162-7 (1958).

8. Int. Rev. Code of 1954, §§ 1371-77.

ship,<sup>9</sup> there has been an additional reason for placing restrictions on the transfer of shares. Among the requirements for eligibility to elect Subchapter S status are the following: (1) the corporation must not have more than ten shareholders;<sup>10</sup> and (2) the shareholders must be individuals or estates.<sup>11</sup> If a shareholder transfers shares to a corporation or a trust or if a shareholder divides his shares and transfers them to a number of persons so as to create more than ten holders of shares, the corporation loses its privilege to elect Subchapter S treatment. Furthermore, even if the shares are transferred to an eligible shareholder, his consent to the continuance of the election of Subchapter S status must be obtained.<sup>12</sup> Therefore, whenever shareholders plan to cause the corporation to elect Subchapter S status, it is wise to place restrictions on the transferability of stock in order to prevent the untimely termination of that status by a transfer of shares to an ineligible holder, to a holder who will not consent or to a number of outsiders so as to increase the total number of shareholders to more than ten.

There are many varieties of restrictions on the transferability of shares. The most useful are the following: (1) consent restraints, *i.e.*, restrictions on transfers which require the consent of the directors, of the other shareholders or of a designated percentage of one of these groups; (2) provisions limiting transfers to specified classes of persons; (3) "first option" provisions, *i.e.*, provisions giving the corporation or the other shareholders "first right" to buy the shares of a holder who decides to sell; (4) options empowering the corporation, its officers or directors, or the other shareholders to purchase the shares of a holder on the happening of specified events—for example, his death or incapacity, or the termination of his employment with the corporation; (5) buy-out arrangements for the transfer of a deceased holder's shares to the corporation or to the other shareholders at a specified price or at a price to be determined by formula; (6) provisions for the redemption ("call") of common stock at the option of the corporation or its board of directors.

Courts sustain restrictions that they characterize as "reasonable."<sup>13</sup> Absolute restrictions unlimited in time on the alienability of

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9. "Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." Int. Rev. Code of 1954, § 701. "In determining his income tax, each partner shall take into account separately his distributive share of the partnership's [profits] . . ." Int. Rev. Code of 1954, § 702(a).

10. Int. Rev. Code of 1954, § 1371(a)(1).

11. Int. Rev. Code of 1954, § 1371(a)(2).

12. Int. Rev. Code of 1954, § 1372(a) requires unanimous shareholder consent for election of Subchapter S status.

13. See *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926). The underlying test seems to be whether the restraint is sufficiently needed by the particular corporation

shares have almost invariably been held invalid as unreasonable.<sup>14</sup> Factors which the Michigan courts have considered in determining whether restrictions are reasonable include the following: (1) the size of the corporation;<sup>15</sup> (2) the likelihood of the restrictions contributing to the attainment of corporate objectives;<sup>16</sup> (3) the length of time the restriction is to remain in effect;<sup>17</sup> and (4) the likelihood that the restriction will promote the best interests of the enterprise as a whole.<sup>18</sup> Other courts have also considered the degree of restraint on the power to alienate,<sup>19</sup> the possibility that a hostile shareholder would injure the corporation<sup>20</sup> and the method to be used in determining the transfer price of the shares.<sup>21</sup>

Enough cases have now been decided in other American jurisdictions, although perhaps not in Michigan, to give the Michigan lawyer reasonable guidance on the kinds of restrictions that will be sustained. The consent restraint is widely used in England and is unquestionably valid there.<sup>22</sup> In this country the earlier cases declared the consent restraint to be invalid as an unreasonable restriction of alienability.<sup>23</sup> However, consent restraints have now been upheld in Michigan and in a number of other states.<sup>24</sup> Buy-and-sell agreements and other buy-out

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to overcome the general policy against restraints on alienation. See 87 U. Pa. L. Rev. 482, 483 (1939). Courts seem more willing to sustain stock transfer restrictions in close corporations than in widely held enterprises. *Id.*

14. See Annot., 65 A.L.R. 1159, 1165 (1930); 18 Iowa L. Rev. 88 (1932). Absolute restrictions for a fairly short period of time, however, have been adjudged valid. See *W. O. Barnes Co. v. Folsinski*, 337 Mich. 370, 60 N.W.2d 302 (1953); *Hornstein*, *Judicial Tolerance of the Incorporated Partnership*, 18 *Law & Contemp. Prob.* 435, 447 (1953).

15. See *Bohnsack v. Detroit Trust Co.*, 292 Mich. 167, 290 N.W. 367 (1940); *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926); *People ex rel. Rudaitis v. Galskis*, 233 Ill. App. 414, 420 (1924); *In re West Waterway Lumber Co.*, 59 Wash. 2d 310, 317, 367 P.2d 807, 811-12 (1962).

16. See *W. O. Barnes Co. v. Folsinski*, 337 Mich. 370, 60 N.W.2d 302 (1953); *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926); *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 352, 152 A. 723, 727 (Sup. Ct. 1930).

17. See *W. O. Barnes Co. v. Folsinski*, 337 Mich. 370, 60 N.W.2d 302 (1953); *Tracey v. Franklin*, 30 Del. Ch. 407, 413-14, 61 A.2d 780, 783-84 (Ch. 1948), *aff'd*, 31 Del. Ch. 477, 484, 67 A.2d 56, 59-60 (Sup. Ct. 1949).

18. See *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926).

19. See *People ex rel. Malcolm v. Lake Sand Corp.*, 251 Ill. App. 499, 504 (1929); *In re Schwartz' Will*, 30 Misc. 2d 814, 816, 219 N.Y.S.2d 545, 547 (Surr. Ct. 1961).

20. See *People ex rel. Rudaitis v. Galskis*, 233 Ill. App. 414, 420 (1924).

21. See *Security Life & Accident Ins. Co. v. Carlovitz*, 251 Ala. 508, 510, 38 So. 2d 274, 276 (1949).

22. See Gower, *Some Contrasts Between British and American Corporation Law*, 69 *Harv. L. Rev.* 1369, 1377-78 (1956).

23. See, e.g., *Morris v. Hussong Dyeing Mach. Co.*, 81 N.J. Eq. 256, 86 A. 1026 (Ch. 1913); *In re Klaus*, 67 Wis. 401, 29 N.W. 582 (1886).

24. See, e.g., *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926); *Schaffer v. Below*, 278 F.2d 619 (3d Cir. 1960); *Mason v. Mallard Tel. Co.*, 213 Iowa 1076, 240 N.W. 671 (1932); 68 *Beacon St., Inc. v. Sohler*, 289 Mass. 354, 194 N.E. 303 (1935). See also 2 F. O'Neal, *Close Corporations* §§ 7.09-10 (1958) [hereinafter cited as O'Neal].

arrangements have been held valid in Michigan<sup>25</sup> and elsewhere. Not only have the courts consistently held that buy-out arrangements are not testamentary,<sup>26</sup> but they have also granted specific performance of such agreements.<sup>27</sup> Courts in almost all jurisdictions (including Michigan) now uphold first option provisions, at least if the provisions are typical and do not contain unusual and peculiarly restrictive terms.<sup>28</sup> Redeemable common stock is permissible in some jurisdictions but of questionable validity in others.<sup>29</sup>

The lawyer must use caution in determining whether to place the transfer restrictions in the articles of incorporation, in the bylaws, in a separate shareholders' agreement or in more than one of these documents. Irrespective of where the restrictions are placed, it is necessary to state the restrictions, or at least make some reference to them, on the share certificates themselves.<sup>30</sup>

The Michigan General Corporation Act refers to share "restrictions" in three sections,<sup>31</sup> but does not lay down standards for determining which restrictions are valid. The three statutory references suggest that the restrictions must be included in the articles of incorporation.<sup>32</sup> A Colorado case,<sup>33</sup> applying statutory language identical to

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25. See *W. O. Barnes Co. v. Folsinski*, 337 Mich. 370, 60 N.W.2d 302 (1953).

26. See, e.g., *Chase Nat'l Bank v. Manufacturers Trust Co.*, 265 App. Div. 406, 39 N.Y.S.2d 370 (1943).

27. See *Bohnsack v. Detroit Trust Co.*, 292 Mich. 167, 290 N.W. 367 (1940); *Johnson v. Johnson*, 87 Colo. 207, 286 P. 109 (1930). In the latter case the court indicated that specific performance would be the proper remedy, although the cause was remanded for a determination of whether the purchase option was exercised within a reasonable time. The arrangement was unique in that it operated as a buy-out procedure although the purchase option did not extend to the shareholder's entire interest, but only to a sufficient number of shares to insure a transfer of a majority interest.

28. See, e.g., *Weiland v. Hogan*, 177 Mich. 626, 143 N.W. 599 (1913); *Evans v. Dennis*, 203 Ga. 232, 46 S.E.2d 122 (1948); *Taylor's Adm'r v. Taylor*, 301 S.W.2d 579 (Ky. Ct. App. 1957), discussed in 46 Ky. L.J. 618 (1958); *Larson v. Superior Auto Parts, Inc.*, 275 Wis. 261, 81 N.W.2d 505 (1957).

29. For a case in which redeemable common stock was held valid see *Lewis v. H.P. Hood & Sons, Inc.*, 331 Mass. 670, 121 N.E.2d 850 (1954); accord *Mich. Comp. Laws* §§ 450.17(b), (d) (1948), as amended, *Mich. Stat. Ann.* §§ 21.17(b), (d) (Supp. 1968).

30. *Straits Transit, Inc. v. Union Terminal Piers*, 370 Mich. 274, 121 N.W.2d 679 (1963); *Goodbar Inv. Co. v. Detroit Bank & Trust Co.*, 4 Mich. App. 218, 144 N.W.2d 649 (1966). See *Mich. Comp. Laws* §§ 440.8103-.8104 (1948), *Mich. Stat. Ann.* §§ 19.8103-.8104 (1963).

31. *Mich. Comp. Laws* §§ 450.4, .17, .25 (1948), as amended, *Mich. Stat. Ann.* §§ 21.4, .17, .25 (Supp. 1968).

32. The language of *Mich. Comp. Laws* § 450.4 (1948), *Mich. Stat. Ann.* § 21.4 (1963), is typical: "Articles of incorporation . . . shall state . . . the total number of shares . . . and (3) a statement of all or any of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof . . ."

33. *Age Pub. Co. v. Becker*, 110 Colo. 319, 134 P.2d 205 (1943).

that of the Michigan Act, has held that the restriction must appear in the articles to be valid, thus precluding restrictions imposed only by a shareholders' agreement or a bylaw provision. Nevertheless, the Michigan courts apparently have not adopted this strict interpretation.<sup>34</sup>

In recent years most of the litigation in American courts on share transfer restrictions has involved the interpretation of restrictions rather than the validity of such restraints. This fact indicates that lawyers are not doing a good job of drafting. The lawyer must be extremely careful to use specific and unambiguous language. For instance, in a first option provision he must be careful to state exactly when the option comes into play, what events give the corporation or the other shareholders an option to buy and when the option terminates. It is nearly always clear from a first option provision that the option to buy comes into effect when a shareholder decides to sell to an outsider. But does the option apply to the following situations: a decision by one shareholder to sell to another shareholder;<sup>35</sup> a decision by a shareholder to transfer his shares to a voting trust;<sup>36</sup> or a decision by a person to whom the shares are transferred to retransfer the shares?

Suppose the first option clause provides that when the shareholder sells he will give the other shareholders the first option to buy. Does the selling shareholder have to offer the shares in proportion to their existing holdings, or must he offer the same number of shares to each of the shareholders or must he sell the shares to the other shareholders on a first-come, first-serve basis?

Specific answers must be set forth explicitly in the restrictive provision to these and many other questions if the risk of litigation is to be minimized. The courts have repeatedly said that restrictions on the transfer of stock will be strictly construed.<sup>37</sup> Therefore, if the draftsman does not make his intention clear, it is quite likely that restrictions will fail to achieve their intended purpose. For instance, if a restriction provides that the corporation will have a first option to buy shares of stock in the event of "any transfer," the courts are

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34. See *Halsey v. Boomer*, 236 Mich. 328, 210 N.W. 209 (1926) (decided prior to enactment of this language); *W. O. Barnes Co. v. Folsinski*, 337 Mich. 370, 60 N.W.2d 302 (1953) (decided after enactment).

35. See, e.g., *Guaranty Laundry Co. v. Pulliam*, 198 Okla. 667, 181 P.2d 1007 (1947); *Pomilla v. Baumgardner*, 326 S.W.2d 917 (Tex. Civ. App. 1959).

36. See, e.g., *Gamson v. Robinson*, 284 App. Div. 945, 135 N.Y.S.2d 505 (1954).

37. See, e.g., *Oakland Scavenger Co. v. Gandi*, 51 Cal. App. 2d 69, 83, 124 P.2d 143, 150 (1942); *Carlson v. Ringgold County Mut. Tel. Co.*, 252 Iowa 748, 760, 108 N.W.2d 478, 485 (1961).

quite likely to hold that the option is not applicable to inter vivos gifts, donations by will<sup>38</sup> and transfers by operation of law.<sup>39</sup>

One of the more difficult decisions confronting the draftsman is the selection of a method of fixing the price at which the shares will be transferred. The price-determining arrangement should be established in advance and included in the restrictive provision. Perhaps the most frequently used method of setting the price is fixing it at book value. This is often an unsatisfactory method of determination since book value is usually far different from actual value. A corporation's assets are often carried on its books at an amount which has historical significance only. Furthermore, tax considerations in computing depreciation on assets frequently control the value at which corporate property is recorded on the books. Actual value may be many times book value. Moreover, good will and going concern value are usually not reflected on the books. At the very least, a lawyer who is going to use book value should indicate whether good will is to be included in computing the book value of shares, and if so, how the value of good will is to be calculated.

Another method of determining the transfer price is for the parties to set the value when the restrictive agreement is made, and then from time to time, perhaps every two years, fix a new value. The difficulty encountered with this approach is that the shareholders forget to adjust the price; or one shareholder, seeing that the others are getting along in years and are likely to die first, will not agree to a change in price which accurately reflects appreciation in the value of the corporation's business and assets. As a general proposition, therefore, the fixing of the price from time to time by the shareholders has not proven to be a satisfactory method of determining transfer price.

Other methods for setting the transfer price are: (1) fixing the price at what an outsider will offer;<sup>40</sup> (2) determining the price by capitalization of the company's earnings;<sup>41</sup> and (3) selecting ap-

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38. See, e.g., *Globe Slicing Mach. Co. v. Hasner*, 223 F. Supp. 589 (S.D.N.Y. 1963); *Vogel v. Melish*, 46 Ill. App. 2d 465, 196 N.E.2d 402 (1964).

39. See, e.g., *In re Trilling*, 140 F. Supp. 260 (E.D. Pa. 1956); *Taylor's Adm'r v. Taylor*, 301 S.W.2d 579 (Ky. Ct. App. 1957).

40. However, as was previously noted, a ready market usually does not exist for shares in a closely held enterprise. Furthermore, prospective purchasers may be hesitant to make offers if their bids will fix the price at which other persons will be privileged to buy.

41. Capitalization of earnings to determine transfer price presents several challenging problems. There is the initial difficulty of drafting an agreement that will provide an accurate method of calculating "earnings" and allow for adjustments for abnormal business years and nonrecurring items of profit and expenditure. In the closely held enterprise, profits are usually taken out of the business in the form of salaries, and it is difficult to ascertain what the company's profits actually are. Also, capitalization of



praisers to decide on the value of the shares.<sup>42</sup> A hybrid method of price-fixing that seems to be growing in popularity is an arrangement pursuant to which the parties themselves set the price, stipulate to adjust it from time to time and agree that if they have failed to agree at the adjustment period immediately before the transfer, appraisers will be called in to fix the value of the shares.

### III

#### OPPRESSION OF MINORITY SHAREHOLDERS AND THE SQUEEZE-OUT PROBLEM

The oppression of minority shareholders and "squeeze plays" designed to eliminate them from the business are serious problems in close corporations. Even in a family company discord is common. As a matter of fact, dissension and squeeze plays occur more often in family corporations than in other close corporations.<sup>43</sup>

Every year thousands of small businesses are injured by dissension among the principal owners and the squeeze plays which frequently grow out of such dissidence. Disputes among the owners of a business almost invariably lead to bad publicity, loss of confidence by suppliers and customers, and expensive litigation.<sup>44</sup> Furthermore, the national economy as a whole suffers because many prospective investors in small businesses, hearing about oppression of minority shareholders and squeeze-outs, withhold investment from close corporations. As a result of a squeeze play, a minority shareholder may count the following among his losses: (1) he has been divested of any voice in the control of the corporation;<sup>45</sup> (2) he has been deprived of information about company affairs and corporate decisions;<sup>46</sup> (3) he has been removed from employment with the company;<sup>47</sup> (4) his invest-

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earnings presupposes existence of going concern value or good will, but in a close corporation withdrawal of the shareholder whose shares are being purchased may seriously diminish good will.

42. If appraisal is the method selected for determining transfer price, the agreement will have to specify a procedure for selecting the appraisers. If more than two or three shareholders are involved, arriving at a suitable plan for appointing appraisers will frequently be difficult. Another disadvantage, particularly evident if the appraisers are directed to apply complicated standards, is that appraisal can become expensive.

43. For family corporation cases involving squeeze plays and open dissension see *Stott Realty Co. v. Orloff*, 262 Mich. 375, 247 N.W. 698 (1933); *Wabunga Land Co. v. Schwanbeck*, 245 Mich. 505, 222 N.W. 707 (1929).

44. See, e.g., *Levant v. Kowal*, 350 Mich. 232, 86 N.W.2d 336 (1956).

45. See, e.g., *Flemming v. Heffner & Flemming*, 263 Mich. 561, 248 N.W. 900 (1933).

46. See, e.g., *Holden v. Lashley-Cox Land Co.*, 316 Mich. 478, 25 N.W.2d 590 (1947).

47. See, e.g., *Batchelder v. Brentwood Lanes, Inc.*, 369 Mich. 155, 119 N.W.2d 630 (1963); *Flemming v. Heffner & Flemming*, 263 Mich. 561, 248 N.W. 900 (1933).

ment has ceased to have any value because he is not receiving either dividends or salary; and (5) he cannot get his money out of the business or even use his interest as security for borrowing.<sup>48</sup>

The techniques for elimination of minority shareholders from a business are almost limitless in number. In 1960 the Duke Law School undertook a study of business squeeze plays, with a view to cataloguing and describing the various squeeze-out techniques. In the beginning the researchers thought that within a few months at most they could discover all of the squeeze-out techniques and develop recommendations to avoid dissension and prevent squeeze-outs. Instead, the job took almost two years.<sup>49</sup> Businessmen, their lawyers and other business advisors, have indeed been prolific and ingenious in devising ways of eliminating undesired business associates.

The simplest and most frequently used squeeze-out technique is the withholding of dividends. Sometimes the approach by majority shareholders is blunt. They simply say to a minority shareholder: "You might as well sell out. As long as you are in the company we're not going to declare any dividends." This is neither the artful nor the wise course of action from the "squeezor's" point of view. Quite often the approach is more subtle. The majority may say to the minority: "Our company's machinery is old; it needs to be replaced. Furthermore, we've got to expand; we've got to set aside reserves for 'a rainy day' when business is not as good as it is now. We can't afford to declare dividends. If you need money now, you'd better sell out and invest in something else. We wish we could give you dividends, but in this company dividend prospects are dim for the next ten years."

Dividends are usually cut off simultaneously with the removal of the shareholder from employment at a time when the "squeezee" needs money badly.<sup>50</sup> Furthermore, if he is on the board of directors he will not be reelected at the next shareholders meeting.<sup>51</sup> Salaries of majority shareholders in their capacities as officers and employees

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48. See, e.g., *Humphrys v. The Winous Co.*, 165 Ohio St. 45, 133 N.E.2d 780 (1956).

49. This study has been published by the Duke University Press, Durham, North Carolina, as F. O'Neal & J. Derwin, *Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises* (1961).

50. See, e.g., *Holden v. Lashley-Cox Land Co.*, 316 Mich. 478, 25 N.W.2d 590 (1947); *Flemming v. Heffner & Flemming*, 263 Mich. 561, 248 N.W. 900 (1933).

51. Mich. Comp. Laws § 450.13(3) (1948), Mich. Stat. Ann. § 21.13(3) (1963), provides that a director may be removed during his term only for cause, and furthermore: "That the shareholders shall have the right to vote cumulatively on such removal and no director shall be removed against whose removal sufficient votes be recorded to have elected a director. . . ." This provision prevents frustration of the mandatory cumulative voting provisions of Mich. Comp. Laws § 450.32 (1948), as amended, Mich. Stat. Ann. § 21.32 (Supp. 1968).

may be increased. Majority shareholders sometimes feel that they are doing more of the company's work once the minority shareholder is no longer employed. In any event, they not uncommonly increase their own salaries. As a result, the majority shareholders live handsomely as well-paid company employees (as do perhaps some of their sisters, cousins and aunts), while the minority shareholder starves if he is dependent solely on the corporation for his income.<sup>52</sup>

Under the "business judgment" rule, courts refuse to interfere with the internal affairs of a corporation as long as the directors are exercising their honest business judgment in making decisions.<sup>53</sup> Judges are not businessmen; they usually do not feel qualified, in the absence of a clear showing of fraud, to determine whether dividends should be paid,<sup>54</sup> whether a particular employee should be discharged or what salary should be paid to a particular officer.<sup>55</sup> Applying the "business judgment" rule, the courts usually refuse to interfere with decisions of directors in the absence of a showing of fraud or bad faith. Also, the judiciary generally feels that majority shareholders should have the power to control the company. As the Michigan Supreme Court noted:

It is not necessary to cite authority in support of the proposition that the majority of the shareholders of a corporation have the right to manage and control the corporate business, and that, in the absence of fraud, acting within their authority, their action is binding on the minority.<sup>56</sup>

After all this nation is a democracy and the majority voice is the voice usually to be heeded and obeyed. The trouble is, in a closely held corporation (*e.g.*, where one person owns forty per cent of the stock and another owns sixty per cent), democracy gets terribly monotonous; the same man is always on the short end of the vote.

In many squeeze plays the squeezors—the majority shareholders—use contracts between the corporation and themselves, or between

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52. For a case in which one family assumed control of a closely held corporation at the expense of another family who owned shares in the enterprise see *Flemming v. Heffner & Flemming*, 263 Mich. 561, 248 N.W. 900 (1933).

53. See, *e.g.*, *Reed v. Burton*, 344 Mich. 126, 73 N.W.2d 333 (1955); *Barrows v. J.N. Fauver Co.*, 280 Mich. 553, 274 N.W. 325 (1937); *Nahikian v. Mattingly*, 265 Mich. 128, 221 N.W. 421 (1934).

54. "While the court has power to order a dividend out of surplus profits—'it will not infringe upon the discretion vested in corporate officers . . .'" *Barrows v. J.N. Fauver Co.*, 280 Mich. 553, 559, 274 N.W. 325, 328 (1937); *Knight v. Alamo Mfg. Co.*, 190 Mich. 223, 157 N.W. 24 (1916). See Annot., 6 A.L.R. 802 (1917).

55. See, *e.g.*, *Barrows v. J.N. Fauver Co.*, 280 Mich. 553, 274 N.W. 325 (1937). But see *Batchelder v. Brentwood Lanes, Inc.*, 369 Mich. 155, 119 N.W.2d 630 (1963).

56. *Crowe v. Consolidated Lumber Co.*, 239 Mich. 300, 303, 214 N.W. 126, 127 (1927).

the corporation and other companies which they control, to siphon off corporate assets. The majority shareholders are in control of the corporation; they are the directors or designate the directors; therefore, they are in a position to cause the corporation to contract with themselves or with companies owned by them. Of course, in theory the majority shareholders are fiduciaries of the corporation, and a corporation can rescind a contract it makes with controlling shareholders if the contract is unfair.<sup>57</sup> But the fact remains that time and again a corporation enters into disadvantageous management<sup>58</sup> or consulting<sup>59</sup> contracts with other corporations which the majority shareholders own; leases property to majority shareholders at an inadequate rental;<sup>60</sup> contracts with majority shareholders or their companies for specified services at a designated rate;<sup>61</sup> lends money to the majority shareholders at no interest or at a low rate,<sup>62</sup> or borrows money from the majority shareholders at a high rate of interest.<sup>63</sup> A minority shareholder may never discover these arrangements or he may not have the money or the will to litigate in the event he can uncover the facts.

There are ways of unfairly treating minority shareholders—and in some instances eliminating them—through the use of fundamental corporate changes, such as charter amendments, mergers and dissolution.<sup>64</sup> Majority shareholders have frequently squeezed out a minority holder by dissolving the corporation and selling its business and assets to a new corporation which has been set up by the majority shareholders to receive those assets.<sup>65</sup> It is also possible under the

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57. See, e.g., *Fenestra, Inc. v. Gulf Am. Land Corp.*, 377 Mich. 565, 141 N.W.2d 36 (1966).

58. See, e.g., *Robb v. Eastgate Hotel, Inc.*, 347 Ill. App. 261, 106 N.E.2d 848 (1952).

59. See, e.g., *Koster v. Warren*, 176 F. Supp. 459 (N.D. Cal. 1959).

60. See, e.g., *Holden v. Lashley-Cox Land Co.*, 316 Mich. 478, 25 N.W.2d 590 (1947); *McKey v. Swenson*, 232 Mich. 505, 205 N.W. 583 (1925); *Brilliant v. Long Island Waste Co.*, 23 Misc. 2d 788, 192 N.Y.S.2d 797 (Sup. Ct. 1959).

61. See, e.g., *Nahikian v. Mattingly*, 265 Mich. 128, 251 N.W. 421 (1934); *Tevis v. Beigel*, 156 Cal. App. 2d 8, 319 P.2d 98 (1957), appeal from retrial, 174 Cal. App. 2d 90, 344 P.2d 360 (1959). See also *Finn Bondholders, Inc. v. Dukes*, 157 Fla. 642, 26 So. 2d 802 (1946).

62. See, e.g., *Mitchell v. Aulander Realty Co.*, 169 N.C. 516, 86 S.E. 358 (1915); *Felsenheld v. Bloch Bros. Tobacco Co.*, 119 W. Va. 167, 192 S.E. 545 (1937).

63. See, e.g., *Tansey v. Oil Producing Royalties, Inc.*, 36 Del. Ch. 472, 133 A.2d 141 (Ch. 1957).

64. In *Detroit & Can. Tunnel Corp. v. Martin*, 353 Mich. 219, 91 N.W.2d 525 (1958), majority shareholders of a corporation originally chartered for the purpose of constructing and operating a tunnel amended the charter to allow the corporation to become an investment company, thus preventing distribution of accrued amortization funds as an earlier charter provision had provided. See also *Wiltse v. Standard Accident Ins. Co.*, 1 Mich. App. 212, 135 N.W.2d 592 (1965).

65. See, e.g., *Porter v. C.O. Porter Mach. Co.*, 336 Mich. 437, 58 N.W.2d 135

Michigan Act to modify the rights of a preferred shareholder by charter amendment, *e.g.*, to reduce his dividend rates or create a new class of shares with prior and superior rights; but the modification cannot destroy or deny any rights which already have vested in him.<sup>66</sup>

Merger has sometimes been used as a procedure to eliminate undesired shareholders. For example, in a Washington case<sup>67</sup> the majority shareholders received an offer from an outsider who wanted to purchase the corporation's shares. The prospective purchaser was not willing to buy anything less than all of the corporate stock, and the minority shareholders would not sell their shares. The majority shareholders thereupon organized a new corporation in which they held all of the common stock. They then arranged a merger of the old corporation into the new. Under the terms of the merger, preferred stock in the new company was issued to all the shareholders of the old corporation (both majority and minority shareholders) in return for their old shares. The preferred stock was redeemable. The obvious plan of the majority shareholders was to redeem the preferred stock so that they would hold all of the stock in a new corporation with the business of the old company. Thereafter they would be in a position to transfer the business to the outside purchaser. The court permitted the merger. Although most courts probably would not approve such a merger plan, this case illustrates that merger can sometimes be effective as a squeeze-out technique.

The holdings of a minority shareholder often can be diluted by the issuance of new stock to majority shareholders at a favorable price.<sup>68</sup> The new stock may be issued at a time when the minority shareholders do not have money to exercise their preemptive rights to buy their proportionate part of the new stock, or an effort may be made by majority shareholders to circumvent the minority's pre-

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(1953); *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1942); *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N.Y. 185, 123 N.E. 148 (1919). See generally Hornstein, *Voluntary Dissolution—A New Development in Intracorporate Abuse*, 51 *Yale L.J.* 64 (1941).

66. See *Sutton v. Globe Knitting Works*, 276 Mich. 200, 267 N.W. 815 (1936). Mich. Comp. Laws § 450.43 (1948), Mich. Stat. Ann. § 21.43 (1963), provides that any right, privilege or preference of any class of shareholders may be changed by a majority class vote. Elimination of preemptive rights requires a two-thirds class vote. In either case, where majority shareholders own preferred stock coextensively with their common share holdings, the class voting provisions may not provide protection to minority holders of preferred. See Annot., 105 A.L.R. 1452 (1936).

67. *Matteson v. Ziebarth*, 40 Wash. 2d 286, 242 P.2d 1025 (1952).

68. See, *e.g.*, *Hyman v. Velsicol Corp.*, 342 Ill. App. 489, 97 N.E.2d 122 (1951). Nor is this technique limited to use by majority shareholders who are in control of the board of directors. See *Kullgren v. Navy Gas & Supply Co.*, 110 Colo. 454, 135 P.2d 1007 (1943), in which controlling minority shareholders sought to issue new shares for the express purpose of entrenching themselves in power.

emptive rights.<sup>69</sup> The Michigan General Corporation Act provides that shareholders' preemptive rights may be limited or denied in the articles of incorporation.<sup>70</sup> Thus, majority shareholders, if they control enough shares to amend the articles, can eliminate minority shareholders' preemptive rights. Furthermore, even without a charter amendment, stock issued for "consideration other than cash" is not subject to preemptive rights.<sup>71</sup>

#### IV

##### MINORITY SHAREHOLDER REMEDIES IN MICHIGAN

An oppressed minority shareholder has a variety of remedies—both under the Michigan General Corporation Act and under common law rules limiting the actions of majority shareholders and directors. An initial weapon which a shareholder might employ effectively to lay groundwork for a later action is the common law<sup>72</sup> and statutory<sup>73</sup> right to inspect corporate books and records.<sup>74</sup> This right extends to any data—letters, contracts, tax returns—pertinent to the object of the shareholder's inspection,<sup>75</sup> and he is entitled to the assistance of an attorney or an accountant.<sup>76</sup> Though inspection usually takes place in the corporate offices, in exceptional circumstances the shareholder may be allowed to remove the pertinent documents for copying.<sup>77</sup> Utilization of inspection rights, however, is generally only a preliminary step to further action against the corporation or its majority shareholders.

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69. See *Essex v. Essex*, 141 Mich. 200, 104 N.W. 622 (1905). The "squeezors" may utilize any of several exceptions to preemptive rights. See 40 Calif. L. Rev. 132, 139 (1952); 35 U. Colo. L. Rev. 482 (1963).

70. Mich. Comp. Laws § 450.13 (1948), Mich. Stat. Ann. § 21.13 (1963).

71. Mich. Comp. Laws § 450.13(a) (1948), Mich. Stat. Ann. § 21.13(a) (1963). Quaere whether this exception would include stock issued to satisfy stock options given to directors and key employees or whether these would come within the "obligations convertible into shares" inclusion in the preamble.

72. See, e.g., *Bishop v. Walker*, 9 Mich. 328 (1861).

73. See Mich. Comp. Laws § 450.45 (1948), Mich. Stat. Ann. § 21.45 (1963). This section also mandates annual distributions of a statement of the "properties and operations" of the corporation. Reliance on this statement, however, might be misplaced. See *Holden v. Lashley-Cox Land Co.*, 316 Mich. 478, 25 N.W.2d 590 (1947), where the minority shareholders were furnished false financial data.

74. Inspection will lie only for a "proper purpose," but the corporation has the burden of proving that the purpose is improper. See *Woodworth v. Old Second Nat'l Bank*, 154 Mich. 459, 117 N.W. 893 (1908); *George v. International Breweries, Inc.*, 1 Mich. App. 129, 134 N.W.2d 381 (1965).

75. See Note, *Shareholder Inspection Rights*, 12 Sw. L.J. 61, 62-66 (1958).

76. See *Woodworth v. Old Second Nat'l Bank*, 154 Mich. 459, 117 N.W. 893 (1908).

77. See *Brandt Glass Co. v. New Orleans Housing Mart, Inc.*, 193 So. 2d 321 (La. 1966).

As has been noted previously, majority shareholders most frequently prefer to take their earnings from the corporation in the form of salaries or similar payments rather than dividends. To prevent abuse of this practice, the courts have placed equitable limitations on directors' and officers' salaries.<sup>78</sup> The operative theory is that overpayment constitutes waste of corporate assets. Each case involves a determination of whether the salary bears a reasonable relation to the value of the services rendered.<sup>79</sup> Frequently a suit for the return of excessive compensation is coupled with a demand for payment of dividends; however, the courts, relying on the "business judgment" rule, are not likely to enforce this demand.<sup>80</sup>

In an extreme situation, the minority shareholder might seek receivership or ask for dissolution of the corporation. Michigan courts have traditionally held that such a drastic remedy will be granted *only* where the corporation has failed to fulfill its business purpose, *i.e.*, to return a profit for its shareholders.<sup>81</sup> While the power of the Michigan courts to dissolve a corporation is inherent, the power is sparingly exercised. Many other states, however, have now added statutory "dissolution-on-deadlock" provisions which broaden this remedy considerably.<sup>82</sup>

There are at least two statutory rights of which the minority shareholder should be cognizant. Section 32 of the Michigan General Corporation Act<sup>83</sup> provides for mandatory<sup>84</sup> cumulative voting in all elections for directors. Thus, in a corporation with three directors, a shareholder with 25.25 per cent of the voting shares can elect one director<sup>85</sup> if all directors are elected each year. However, section 13(4)

78. See *Balchelder v. Brentwood Lanes, Inc.*, 369 Mich. 155, 119 N.W.2d 630 (1953); *Miner v. Belle Isle Ice Co.*, 93 Mich. 97, 53 N.W. 218 (1892).

79. For a discussion of the more relevant factors in this area see 2 O'Neal § 8.12. The corporation, for federal income tax purposes, can deduct only "reasonable" salaries. See Int. Rev. Code of 1954, § 162(a)(1).

80. See *Barrows v. J.N. Fauver Co.*, 280 Mich. 553, 274 N.W. 325 (1937); *Knight v. Alamo Mfg. Co.*, 190 Mich. 223, 157 N.W. 24 (1916); Annot., 6 A.L.R. 789 (1917). But see *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919). Int. Rev. Code of 1954, §§ 531-37, which imposes a surtax on an unreasonable accumulation of earnings, has a tendency to aid the minority shareholder caught in this situation.

81. Extreme dissension among the participants is another characteristic of these cases. See, e.g., *Levant v. Kowal*, 350 Mich. 232, 86 N.W.2d 336 (1957); *Holden v. Lashley-Cox Land Co.*, 316 Mich. 478, 25 N.W.2d 590 (1947); *Edison v. Fleckenstein Pump Co.*, 249 Mich. 234, 228 N.W. 705 (1930); *Miner v. Belle Isle Ice Co.*, 93 Mich. 97, 53 N.W. 218 (1892).

82. See, e.g., N.Y. Bus. Corp. Law § 1104.

83. Mich. Comp. Laws § 450.32 (1948), Mich. Stat. Ann. § 21.32 (1963).

84. See [1939-40] Mich. Att'y Gen. Biennial Rep. 155.

85. The formula is  $X = \frac{ab + 1}{c + 1}$  where "a" is the number of directors desired

of the Act contains a provision which permits staggered elections of directors. For example, in a 1967 case, *McDonough v. Copeland Refrigeration Corp.*,<sup>86</sup> a Michigan federal district court held that a by-law changing the annual term of a nine-man board to a three-year term with three directors being elected each year was not invalid as contravening the Michigan cumulative voting provision. The only limitation is that at least one director must be elected each year.<sup>87</sup> Another technique which an oppressive majority might employ is the use of a two-man executive committee, elected by a majority of the directors<sup>88</sup> to manage the affairs of the corporation during the periods between full board meetings.<sup>89</sup>

The second statutory provision intended to safeguard the investment of the minority shareholder is his right, upon his dissenting to a sale, lease or exchange of all or substantially all of a corporation's assets<sup>90</sup> or on the authorization of a plan of merger or consolidation<sup>91</sup> by the shareholders,<sup>92</sup> to have his shares purchased by the corporation at a price set by independent appraisers. Though the statute says that appraisal is the shareholder's exclusive remedy,<sup>93</sup> the Michigan Supreme Court has indicated that an attack based on fraud or bad faith might still be allowed.<sup>94</sup> Unfortunately, enforcement of this remedy is often expensive and time-consuming.

## V

### ARRANGEMENTS WHICH AVOID DISSENSION AND SQUEEZE-OUTS

Advance planning can reduce dissension among the participants in a closely held corporation and minimize the risk of squeeze-outs.

to be elected, "b" is the total number of shares to be voted, "c" is the total number of vacancies to be filled, and "X" is the number of shares needed to elect the desired number of directors.

86. 277 F. Supp. 6 (E.D. Mich. 1967).

87. Mich. Comp. Laws § 450.13(4) (1948), Mich. Stat. Ann. § 21.13(4) (1963).

88. This is expressly authorized by Mich. Comp. Laws § 450.13(4)(d) (1948), Mich. Stat. Ann. § 21.13(4)(d) (1963).

89. There is no express statutory mandate requiring annual meetings of directors; however, Mich. Comp. Laws § 450.45 (1948), Mich. Stat. Ann. § 21.45 (1963), which requires an annual financial statement, clearly envisions such a result. Even if the minority board member is excluded from the executive committee, and thus from effective participation in policy formulation, he still has the expanded right, granted directors, to inspect the books and records. See *Leach v. Davy*, 199 Mich. 378, 165 N.W. 927 (1917).

90. Mich. Comp. Laws § 450.44 (1948), Mich. Stat. Ann. § 21.44 (1963).

91. Mich. Comp. Laws § 450.54 (1948), Mich. Stat. Ann. § 21.54 (1963).

92. In *Pollack v. Adwood Corp.*, 321 Mich. 93, 32 N.W.2d 62 (1948), the directors leased the sole income producing property of the corporation. The Michigan Supreme Court held that the statute was inapplicable since it applied only where the shareholders had authorized the lease and did not apply to acts by directors.

93. Mich. Comp. Laws § 450.44(2) (1948), Mich. Stat. Ann. § 21.44(2) (1963).

94. See *Porter v. C.O. Porter Mach. Co.*, 336 Mich. 437, 56 N.W.2d 135 (1953); *Neef & Sullivan, The Close Corporation in Michigan*, 39 Mich. S.B.J. 8, 20 (July 1960).



The first step counsel should take to avoid dissidence and prevent squeeze plays is to study carefully the underlying causes of dissension in close corporations. Many squeeze-outs are, of course, attributable to the avarice of unscrupulous men who take advantage of trusting or less able associates. Nevertheless, squeeze-outs result less often from sheer grabs for power or profit than might be supposed. Most squeeze-out cases are characterized by basic conflicts of interest, protracted policy disagreements or demonstrated inability of those who are squeezed out to carry a fair share of the responsibility and effort involved in operating a business.

Nor is right always with the minority owners. Quite often minority shareholders are so uncooperative and unreasonable that majority owners cannot be blamed for attempts to eliminate them from the business. Indeed, obstreperous conduct of minority owners is sometimes an attempt on their part to compel majority owners to buy their interests at exorbitant prices. Also, minority owners sometimes conclude that they are being squeezed when their dissatisfaction can reasonably be attributed to other causes. They may live far from the place where the enterprise is conducted. Perhaps they do not understand the business or its problems, or, for any number of reasons, they may not be in a position to play leading roles in its operation. Real squeeze plays are sometimes hard to distinguish from cases of imagined injustice grounded in frustration or unrealistic expectation.

Trouble most often develops when one of the original participants in an enterprise becomes inactive or his interest is acquired by an inactive owner—for example, his widow.<sup>95</sup> In such a situation differences are especially likely to develop over the allocation of profits between salaries and dividends. When all shareholders in a corporation devote full time to its affairs, they ordinarily take most of its earnings in salaries rather than dividends in order to minimize taxation.<sup>96</sup> If, however, there are shareholders who are not on the payroll this practice obviously will be unsatisfactory to them.

Other patterns that may lead to serious dissension include: (1) The aged founder of a business, who perhaps has always run it as a one-man show, becomes increasingly tyrannical, ignoring wishes of co-owners and insisting on outmoded business methods.<sup>97</sup> (2) The more competent and energetic participants in an enterprise feel that the others are holding the enterprise back or are getting an unduly large portion of its earnings.<sup>98</sup> (3) One of the owners of a

95. See, e.g., *In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954).

96. See p. 725 & note 7 *supra*.

97. See, e.g., *Tansey v. Oil Producing Royalties, Inc.*, 36 Del. Ch. 472, 133 A.2d 141 (Ch. 1957).

98. See, e.g., *Black v. Parker Mfg. Co.*, 329 Mass. 105, 106 N.E.2d 544 (1952).

business acquires an interest in a competing enterprise.<sup>99</sup> (4) A business is organized to exploit a new invention or patent, with the inventor receiving an interest in the new enterprise. However, no provision is made for the company to acquire rights to new competitive discoveries of the inventor or to compensate him for improvements made on his original invention.<sup>100</sup> (5) A considerable number of people, perhaps employees of the corporation, are each issued a small number of shares. The business prospers and grows. Eventually some of the small shareholders demand dividends on what they consider valuable property, or they attempt to create conflicts among the larger shareholders.

The inability of holders of minority interests to dispose of their interests without serious financial loss undoubtedly intensifies dissension which leads to squeeze-outs.<sup>101</sup> Moreover, the difficulty of determining the value of an interest in a small business—*e.g.*, when one of the owners decides to sell his interest to his associates—often sparks dissension from which the ugly drama of a squeeze-out gradually unfolds.<sup>102</sup>

The neglect of small businessmen to obtain legal advice at the time a business is being organized; the failure of lawyers, when consulted, to foresee problems that might arise out of transitions in ownership and control, and to take steps to meet those problems; the failure to put all aspects of the business agreement into writing<sup>103</sup>—these errors must bear a large part of the blame for allowing situations to develop in which a squeeze-out seems the easiest, if not the only, solution.

The lawyer has a number of affirmative measures at his disposal at the time a business is being organized or before friction has developed to prevent oppression and to avoid squeeze plays. The most frequently used arrangements are: (1) restrictions on transfer of stock and buy-out arrangements; (2) charter or bylaw provisions establishing high vote requirements for shareholder and director action; (3) shareholders' agreements; (4) long-term employment contracts between corporation and shareholder; (5) arrangements for settling disputes.

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99. See Calder, *Cases in the Management of Small, Family Controlled Manufacturing Businesses*, Case 3, in *Indiana Case Studies in Business* 57 (No. 2, 1954).

100. See, *e.g.*, *Hyman v. Velsicol Corp.*, 342 Ill. App. 489, 97 N.E.2d 122 (1951); *Crichton v. Webb Press Co.*, 113 La. 167, 36 So. 926 (1904).

101. See, *e.g.*, *Connelly v. Weisfeld*, 142 N.J. Eq. 406, 408, 59 A.2d 869, 871 (Ct. Err. & App. 1948).

102. See, *e.g.*, *Fortugno v. Hudson Manure Co.*, 51 N.J. Super. 482, 144 A.2d 207 (App. Div. 1958).

103. See, *e.g.*, *Bellows v. Porter*, 201 F.2d 429 (8th Cir. 1953); *Martin v. Stone*, 332 Mass. 540, 126 N.E.2d 196 (1955).

Restrictions on the transferability of stock have already been discussed.<sup>104</sup> They decrease the chances of dissension by preventing shares from getting into the hands of persons who will not be active in the enterprise. Subsequent sections of this article discuss in some detail the other arrangements for avoiding squeeze-outs.

*A. Giving Shareholders a Veto Over Corporate Decisions: High Vote Requirements for Shareholder and Director Action*

Perhaps the most effective way of protecting a minority shareholder against a squeeze-out is to include in the articles a provision requiring high vote or high quorum requirements for shareholder and director action. Such provisions are authorized by the Michigan General Corporation Act. Section 32 deals with shareholder action.

[T]he articles of any corporation may specify the number of shares or the amount of other securities having voting power the holders of which shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business.<sup>105</sup>

Section 13(4) permits high votes and high quorums for director action. That section, which provides that a majority of directors constitutes a quorum and that a majority of votes at a meeting where there is present a quorum shall be the acts of the directors, is prefaced with the language "except as otherwise prescribed in the articles or bylaws."<sup>106</sup>

Obviously if a favorable vote of holders of eighty-five per cent of the shares outstanding is required for shareholder action, a person who holds twenty per cent of the shares is in a position to prevent shareholder approval of any resolution he finds objectionable. The shareholders elect the directors, at least in the absence of a shareholders' agreement designating the directors;<sup>107</sup> and under most modern corporation statutes, including Michigan's statute, shareholder approval is required for fundamental corporate acts such as charter amendment,<sup>108</sup> sale of all assets,<sup>109</sup> merger,<sup>110</sup> consolidation<sup>111</sup> or dis-

104. See pp. 725-31 *supra*.

105. Mich. Comp. Laws § 450.32 (1948), Mich. Stat. Ann. § 21.32 (1963).

106. Mich. Comp. Laws § 450.13(4) (1948), Mich. Stat. Ann. § 21.13(4) (1963). See Neef & Sullivan, *supra* note 94, at 15-18. See also Mich. Comp. Laws § 450.4(2) (1948), Mich. Stat. Ann. § 21.4(2) (1963).

107. Quære the validity of a shareholders' agreement designating a director in Michigan. See the excellent discussion of shareholders' agreements in Neef & Sullivan, *supra* note 94, at 14-16.

108. Mich. Comp. Laws §§ 450.42-43 (1948), Mich. Stat. Ann. §§ 21.42-43 (1963).

109. Mich. Comp. Laws § 450.57 (1948), Mich. Stat. Ann. § 21.57 (1963).

110. Mich. Comp. Laws § 450.52 (1948), as amended, Mich. Stat. Ann. § 21.52 (Supp. 1968).

111. *Id.*

solution.<sup>112</sup> A high vote requirement for shareholder action gives a minority shareholder a veto over the personnel of the directorate and protects him against the various squeeze-out techniques which involve fundamental corporate acts.

A high vote requirement for shareholder action alone, however, does not give a veto over many management or policy actions which might lend themselves to squeeze-outs. To protect a minority shareholder against certain types of squeeze plays, he must be given a veto power over action within the province of the board of directors—including the hiring and discharge of employees, changes in employees' compensation, execution of contracts, lending of money and issuance of additional corporate stock. To give a minority shareholder a veto over acts of this kind, it is necessary to establish a high vote for director action coupled with an arrangement which assures the minority shareholder representation on the board of directors.<sup>113</sup>

A shareholder can be assured of representation on the board of directors in a number of ways. Not uncommonly, when a small corporation is organized, each shareholder is given membership on the initial board. If a shareholder is on the first board of directors and a high vote is required for shareholder action, he can prevent the election of a new board. In most states the old board carries over until a new board is elected and qualifies. Another method, as yet untested in Michigan, of giving a minority shareholder representation on the board is a unanimous shareholders' agreement which designates him or his nominee as a director.<sup>114</sup> A third possibility is the classification of shares, giving the minority shareholder all the shares of one class and providing that each class of shares will elect a designated number of directors. It is quite common now in small corporations for stock to be classified into a number of classes, the only difference between the classes being that each class elects a different director or group of directors.<sup>115</sup>

Even though high vote requirements are perhaps the most effective safeguards against squeeze-outs, the protection they give minority shareholders must be weighed against the risks and disadvantages they

112. Mich. Comp. Laws §§ 450.65-.74 (1948), Mich. Stat. Ann. §§ 21.65-.74 (1963).

113. The mandatory cumulative voting provisions of Mich. Comp. Laws § 450.32 (1948), Mich. Stat. Ann. § 21.32 (1963), will help insure this representation. See note 51 *supra*.

114. See Neef & Sullivan, *supra* note 94, at 14.

115. This is permitted by Mich. Comp. Laws § 450.17 (1948), Mich. Stat. Ann. § 21.17 (1963). Ability to elect Subchapter S status, see pp. 725-26 & notes 8-12 *supra*, must also be considered when classification of a corporation's stock is contemplated. To qualify for this special tax treatment a corporation must not "have more than one class of stock." Int. Rev. Code of 1954, § 1371(a)(4).

impose upon the company and majority shareholders. There are several important points that should be considered. First, a shareholder may use his veto power to extort unfair concessions from his associates as a condition to giving his approval to desired corporate action. Second, veto arrangements deprive a corporation of the flexibility which it may need to adjust to new situations. Third, high voting requirements greatly increase the chance of deadlock and corporate paralysis, raising the difficult question of what arrangements can be set up to break deadlocks when they develop.

To minimize the disadvantages of veto arrangements, the scope of the veto can be limited to areas in which it is felt protection is most needed by the minority shareholder—perhaps to fundamental corporate action and to decisions on the employment and discharge of key employees and the fixing of their compensation. Naturally, the risk of deadlock increases as the number of shareholders increases; and if a corporation is to have more than four or five shareholders, it may be unwise to give a single shareholder power to veto corporate action. In a corporation with seven shareholders and a seven-man board, for instance, it may be preferable to set the vote for shareholder and director action in a manner which requires concurrence of two shareholders or directors to effect a veto.

### *B. Shareholders' Agreements*

Undoubtedly the most frequently used device for affording protection to minority shareholders against squeeze-outs is a contract among the shareholders.<sup>116</sup> One reason for the frequency with which shareholders' agreements are employed is the relative ease of preparing such agreements. Among provisions which have been used in shareholders' agreements to help forestall squeeze-outs are: (1) specified shareholders or their nominees are to constitute the board of directors; (2) each shareholder is to be employed in a key position by the corporation at a specified salary; (3) salaries of officers and other key employees are not to be changed except by unanimous consent of the shareholders; (4) each shareholder or specified group of shareholders is to have the power to veto some or all corporate decisions; (5) a shareholder is not to acquire an interest in or employment with a competing concern; (6) whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess will be paid to

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116. See generally 1 O'Neal §§ 5.01-.40; Hoban, *Voting Control Methods*, 1958 U. Ill. L.F. 110; Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 Yale L.J. 1040 (1950); Scott, *The Close Corporation in Contemporary Business*, 13 Bus. Law. 741, 748-52 (1958).

the shareholders; (7) a shareholder will not transfer his shares until he has first offered them to the corporation, the other shareholders, or both; (8) disputes among the participants are to be submitted to arbitration for settlement. The parties might also consider including in the agreement a statement that a breach of the covenants therein will result in irreparable damage, which damage is not measurable in money, and that therefore the parties agree to injunctive relief to compel compliance.

A lawyer preparing a shareholders' agreement should study the applicable state law with great care to determine whether the provisions he wants to use are legal, and he should use caution in drafting the provisions.<sup>117</sup> Shareholders' agreements are the subject of litigation more often than most lawyers realize. Generally they are challenged as violating the statutory provision vesting management of the business and affairs of the corporation in the board of directors.<sup>118</sup> Nevertheless, provisions of this type—to the extent that they will be given effect by the courts—set up a bulwark against some of the more common squeeze-out techniques. For example, if a person buying a minority interest in a close corporation insists upon a shareholders' agreement which assures him that he will be employed by the corporation at a specified salary and that if salaries are raised his salary will be increased in proportion to those of other participants, he protects

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117. For a detailed discussion of considerations affecting the validity of shareholders' agreements and of planning and drafting precautions to strengthen such agreements see 1 O'Neal, ch. 5. See also Neef & Sullivan, *supra* note 94, at 8.

118. Mich. Comp. Laws § 450.13(1), (4) (1948); Mich. Stat. Ann. § 21.13(1), (4) (1963). See p. 741 & notes 106-07 *supra*. Cf. *Ayers v. Hadaway*, 303 Mich. 589, 6 N.W.2d 905 (1942).

A shareholders' agreement providing that a particular individual will have a long-term contract as an officer of the corporation is susceptible to attack on the bases that: (1) it usurps the statutory power, Mich. Comp. Laws § 450.13 (1948), Mich. Stat. Ann. § 21.13 (1963), of the board of directors to manage the corporation's affairs, see, e.g., *Abbot v. Harbeson Textile Co.*, 162 App. Div. 405, 147 N.Y.S. 1031 (1914); (2) it violates the statute providing that directors shall select corporate officers, Mich. Comp. Laws § 450.15 (1948), Mich. Stat. Ann. § 21.15 (1963); (3) it tends to cause the directors to disregard their fiduciary duties to the corporation and to other shareholders, see, e.g., *Scripps v. Sweeney*, 160 Mich. 148, 125 N.W. 72 (1910); *Dubbs v. Kramer*, 302 Pa. 455, 153 A. 733 (1931); and (4) it may be abusive or unfair to noncontracting shareholders, see, e.g., *Wilbur v. Stoepel*, 82 Mich. 344, 46 N.W. 724 (1890); *Odman v. Oleson*, 319 Mass. 24, 64 N.E.2d 439 (1946).

Furthermore, such a shareholders' agreement would not actually prevent removal of an officer (even though an action for damages might be sustainable because of the removal), for such a provision or interpretation would run afoul of the statutory prescription, Mich. Comp. Laws § 450.15 (1948), Mich. Stat. Ann. § 21.15 (1963), empowering the board of directors to remove officers and employees "whenever in their judgment the business interests of the corporation will be served thereby . . ." See p. 746 & note 121 *infra*.

himself against the possibility that the other shareholders will "gang up" on him and exclude him from company employment while they siphon off corporate earnings by means of high compensation to themselves. Similarly, a provision requiring payment of dividends assures a shareholder that he will get some return on his investment if the business is profitable.

*C. Long-Term Employment Contracts Between Shareholder and Corporation*

Frequently, persons organizing a small business corporation invest practically all their assets in the enterprise. They may expect to devote all of their time to the business and to earn their livelihood largely by working for the enterprise. Therefore, minority shareholders must have assurance that they will be retained in the company's employment. A person who is taking a minority interest can protect himself to some extent against being deprived of employment by insisting on a long-term employment contract. Note that what is contemplated here is not an agreement among the shareholders, but a contract between the corporation and a particular shareholder-employee.<sup>119</sup>

To guard against the possibility that, when the corporation grows and becomes prosperous, the salaries of majority shareholders will be increased without a proportionate increase in the minority shareholder's compensation, he may insist that his employment contract include, in addition to a basic salary, some provision for contingent compensation (e.g., a percentage of profits) or an arrangement under which his salary will be increased in a fixed proportion with the salaries of designated corporate officers. He may also insist that the contract include provisions for severance pay or liquidated damages in the event the corporation breaches the contract, or provisions obligating the corporation to purchase his stock or provide him with a lifetime pension in the event it discharges him or fails to renew his contract.

The protection afforded a minority shareholder by a long-term employment contract, however, is tenuous and incomplete. In the first place, the validity of long-term employment contracts remains rather uncertain in some jurisdictions, including Michigan.<sup>120</sup> Furthermore,

119. See note 118 *supra*.

120. See *Brewer v. Stoddard*, 309 Mich. 119, 14 N.W.2d 804 (1944); *Marvin v. Solvental Chem. Prods., Inc.*, 298 Mich. 296, 298 N.W. 782 (1941); *Scripps v. Sweeney*, 160 Mich. 148, 125 N.W. 72 (1910); *Wilbur v. Stoepel*, 82 Mich. 344, 46 N.W. 724 (1890). In *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich. 582, 24 N.W.2d 220 (1946), the court upheld shareholder approval of a 10-year employment contract given to the

the courts generally will not specifically enforce an employment contract; and damages usually will not be an adequate remedy to a minority shareholder who has invested everything he owns in the company and is depending upon employment by it for his livelihood. Section 5 of the Michigan General Corporation Act provides for removal of officers by the directors, although such removal is without prejudice to the contract rights, if any, of the officer removed.<sup>121</sup> Finally, those in control of a company can make a shareholder-employee's life miserable by refusing to cooperate with him and by taking various other steps to make his work unpleasant or unrewarding, such as effecting changes in his duties and the locale to which he is assigned.

#### *D. Arrangements for Settling Disputes and Breaking Deadlocks*

Often a squeeze play can be avoided by providing in advance—by charter or bylaw provision or shareholders' agreement—an arrangement to resolve whatever policy disagreements or other disputes arise from time to time among participants. Three approaches seem promising. One is an arrangement by which impartial outsiders will be brought in to manage the business until tempers have cooled or the parties have resolved their differences. This can be accomplished through the use of the voting trust.<sup>122</sup> Another approach is to provide in advance for arbitration of whatever disputes arise. In jurisdictions such as Michigan, in which agreements to arbitrate future disputes (including disputes on management and policy questions) will be enforced,<sup>123</sup> arbitration has great potential for settling quickly and satisfactorily many of the controversies which occur in small businesses, thus avoiding the long, drawn-out dissension which leads to so many squeeze plays.<sup>124</sup> The third approach is to establish an arrangement under which one faction of shareholders will buy out the interest of the other in the event a dispute persists for a specified period of time. Such a provision might require the majority shareholder in a two-man company to buy out the minority shareholder at a specified price, if for a period of two years they fail to agree on successors for members

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defendant as general manager, but disapproved a provision giving defendant the office of president for the same period.

121. Mich. Comp. Laws § 450.15 (1948), Mich. Stat. Ann. § 21.15 (1963).

122. The voting trust is authorized by Mich. Comp. Laws § 450.34 (1948), Mich. Stat. Ann. § 21.34 (1963).

123. Mich. Comp. Laws §§ 600.5001, .5025 & Committee Comment (1948), Mich. Stat. Ann. §§ 27A.5001, .5025 & Committee Comment (1963). Cf. *In re Toynnton-Brown Co.*, 308 Mich. 727, 14 N.W.2d 550 (1944).

124. For a discussion of the potentialities of arbitration for settling disputes in close corporations and of the planning and drafting precautions that make arbitration provisions more effective and less vulnerable to attack see 2 O'Neal §§ 9.08-.25.



of the board of directors. Another arrangement, which is becoming popular, provides that any shareholder shall have the right to dissolve the corporation at any time, but prior to exercising his right of dissolution he must first offer his shares to the other shareholders at a specified price or at a price to be determined by formula.

In a two-man company where the shares are evenly divided, the two shareholders sometimes enter into an agreement which provides that either shareholder may at any time set a price which he is willing to take for his interest in the business or to give for the other's interest; the other shareholder will then have a specified period of time within which to decide whether he will buy or sell at that price. No instance has been found where an arrangement of this kind has been used in a company in which one shareholder owned more than half the stock; nevertheless, no reason is apparent why the shareholders in such a company could not employ this type of buy-out arrangement. In that kind of situation the price, instead of being stated in terms of a half-interest in the business, would have to be set at a fixed sum per share.

## VI

### CONCLUSION

In Michigan, as in most jurisdictions including states with corporation statutes based on the Model Act, the legislature has generally applied the same statutory rules to close corporations as to public-issue corporations. Because some provisions of the Michigan statute are ill-adapted to close corporations, it is often difficult for a Michigan lawyer to mold the corporate form to serve the needs of a particular closely held enterprise. Nevertheless, by the use of such devices as have been discussed in this article—restrictions on the transfer of shares, buy-out agreements, high quorum and voting requirements, shareholders' agreements, long-term employment contracts and provisions for the orderly settlement of disputes and deadlocks—the lawyer can in most instances provide a serviceable framework for closely held businesses. By the exercise of imagination and ingenuity, lawyers in other jurisdictions will ill-devised statutes have been able to set up satisfactory business structures for closely held enterprises.

With one exception<sup>125</sup> state legislatures have not seen fit to enact a separate code for closely held corporations. However, a number of jurisdictions, including Delaware, have recently included in their general business corporation acts provisions drafted primarily to satisfy the peculiar needs of close corporations.<sup>126</sup>

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125. See Fla. Stat. Ann. §§ 608.0100-.0106 (Supp. 1966).

126. See, e.g., S.C. Code Ann. §§ 12-11.1 to 12-31.2 (Supp. 1966).

Statutory provisions designed for the close corporation found in recent enactments include the following:<sup>127</sup> (1) statutes permitting a corporation to be formed by a single incorporator;<sup>128</sup> (2) statutes allowing a corporation to have fewer than the traditional minimum of three directors;<sup>129</sup> (3) statutes permitting one man to hold all corporate offices;<sup>130</sup> (4) statutes empowering directors to fix their own compensation as directors and officers;<sup>131</sup> (5) statutes requiring directors to declare dividends in specified circumstances;<sup>132</sup> (6) statutes sanctioning shareholders' agreements allocating corporate control and impinging upon powers traditionally vested in the board of directors, or otherwise departing from the traditional pattern of corporate management;<sup>133</sup> (7) statutes permitting special contractual arrangements among shareholders to establish nonstatutory dissolution criteria and procedures;<sup>134</sup> and (8) statutes authorizing judicial appointment of a provisional director when a corporation's board of directors is evenly divided with respect to management policy.<sup>135</sup>

Enactments such as these take cognizance of the differences between close and public-issue corporations, permitting more realistic structuring of business organization for closely held enterprises. The Michigan Legislature would be well advised to consider amendment of the Michigan General Corporation Act by inserting provisions designed to increase the flexibility of the corporate form to enhance tailoring of the corporate device to better approximate the needs of closely held businesses.

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127. For a more detailed discussion of many of the enumerated statutory provisions see O'Neal, *Recent Legislation Affecting Close Corporations*, 23 *Law & Contemp. Prob.* 341 (1958).

128. See, e.g., Mich. Comp. Laws § 450.3 (1948), Mich. Stat. Ann. § 21.3 (1963); Ill. Ann. Stat. ch. 32, § 157.46 (Smith-Hurd Supp. 1967); Wis. Stat. Ann. § 180.44 (1957). See generally Garrett, *John Doe Incorporates Himself*, 19 *Bus. Law.* 535 (1964); Spoerri, *One Incorporator—One Director*, 19 *Bus. Law.* 305 (1963).

129. See, e.g., Del. Code Ann. tit. 8, § 141(b) (1967); Ill. Ann. Stat. ch. 32, § 157.34 (Smith-Hurd Supp. 1967); Ky. Rev. Stat. Ann. § 271.345(1) (Supp. 1966). The Michigan General Corporation Act requires "at least three directors." Mich. Comp. Laws § 450.13 (1948), Mich. Stat. Ann. § 21.13 (1963).

130. See Del. Code Ann. tit. 8, § 142(a) (1967); Iowa Code Ann. § 496A.45 (1962); Cosson, *The Iowa Business Corporation Act*, 45 *Iowa L. Rev.* 12, 24 (1959). Michigan allows any two offices except president and vice-president to be held by the same person. Mich. Comp. Laws § 450.15 (1948), Mich. Stat. Ann. § 21.15 (1963).

131. See, e.g., Ohio Rev. Code Ann. § 1701.60 (Baldwin 1964); Wis. Stat. Ann. § 180.31 (1957).

132. See, e.g., N.M. Stat. Ann. § 51-3-16 (1953).

133. See, e.g., Del. Code Ann. tit. 8, § 218(c) (1967); N.Y. Bus. Corp. Law § 609; N.C. Gen. Stat. § 55-68 (1965). See p. 738 & notes 89-92 *supra*.

134. See, e.g., N.C. Gen. Stat. § 55-125(3) (1965); Wyo. Stat. Ann. § 17-36.31 (1965).

135. See, e.g., Cal. Corp. Code § 819; Mo. Ann. Stat. § 351.323 (Supp. 1965).